NOS. 03-892 and 03-907

IN THE
Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,*

v.

JOHN W. BANKS, II, *Respondent*

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

SIGITAS J. BANAITIS, *Respondent*

On Writs of Certiorari
to the United States Courts of Appeals
for the Sixth and Ninth Circuits

BRIEF FOR *AMICUS CURIAE*, PROF. STEPHEN B. COHEN, *PRO SE*, IN SUPPORT OF RESPONDENTS

PROF. STEPHEN B. COHEN
COUNSEL OF RECORD, *PRO SE*
GEORGETOWN LAW CENTER
600 NEW JERSEY AVENUE, N.W.
WASHINGTON, D.C. 20001
202-352-8244

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

TABLE OF CONTENTS

INTEREST AND IDENTITY OF *AMICUS* 1

SUMMARY OF ARGUMENT 2

ARGUMENT 5

I. This *Amicus* Brief Presents a New Argument for Excluding the Attorneys' Fees from Taxpayers' Gross Income. 5

A. Gross Income Does not Include Amounts that Qualify under Internal Revenue Code § 62(a)(2)(A) as Reimbursed Employee Business Expenses. 6

B. The Court May Consider an Argument Raised for the First Time in an *Amicus* Brief. 6

II. The Attorneys' Fees Satisfy the Plain Language Requirements of § 62(a)(2)(A). 7

A. The Settlement Agreements Qualify as Reimbursement Arrangements. 8

B. The Fees Arose in Connection with the Performance of Services by the Taxpayers as Employees. 10

C. The Fee Amounts Were Substantiated, and the Taxpayers Did Not Retain Excess Reimbursement Amounts. 14

III. Applying § 62(a)(2)(A) Is Consistent with the Statute's Purpose of Excluding from Taxation Business Expenses that Do Not Provide Personal Consumption Benefits. 15

IV. Applying § 62(a)(2)(A) Avoids a Result that Is Grossly Unfair and Irrational and that Undermines Federal Civil Rights Statutes..... 19

V. The Ninth Circuit's Decision that § 62(a)(2)(A) Cannot Apply to a Former Employee Should Be Rejected. 22

A. The Ninth Circuit Ignored the Rule that Identical Words in the Same Statute Are Presumed to Have the Same Meaning. 23

B. The Ninth Circuit Misinterpreted the Regulations. 26

C. The Ninth Circuit Misread the Legislative History. 27

D. The Ninth Circuit Made No Attempt to Harmonize the Internal Revenue Code with Federal Civil Rights Statutes, Consider § 62(a)(2)(A)'s Purpose, or Heed the Admonition that Congress Cannot Anticipate Every Problem that May Arise. 29

CONCLUSION 30

APPENDIX A-1

I. Internal Revenue Code § 62, 26 U.S.C. § 62 ..... A-1

II. Treasury Regulation § 1.62-2, 26 C.F.R. §1.62-2 ..... A-3

TABLE OF AUTHORITIES

CASES

Adams Fruit Co. v. Barrett,
494 U.S. 638 (1990) 30

Alexander v. Commissioner,
72 F.3d 938 (1st Cir. 1995) ..... passim

Banaitis v. Commissioner,
340 F.3d 1074 (9th Cir. 2003) 5, 9, 14, 15

Banks v. Commissioner,
345 F.3d 373 (6th Cir. 2003) ..... passim

Biehl v. Commissioner,
118 T.C. 467 (2002) 10, 12, 28
351 F.3d 982 (9th Cir. 2003) ..... passim

Bob Jones University v. United States,
461 U.S. 574 (1983) 30

Brenner v. Commissioner,
T.C. Memo 2001-127 14

Cabell v. Markham,
148 F.2d 737 (2d Cir. 1945) 30

City of Riverside v. Rivera,
477 U.S. 561 (1986) 20

Dewey v. Des Moines,
173 U.S. 193 (1899) 7

Digital Equip. Corp. v. Desktop Direct, Inc.,
511 U.S. 863 (1994) 22, 30

Flowers, Commissioner v.,
326 U.S. 465 (1946) 12, 13, 25

Gerbec v. United States,
164 F.3d 1015 (6th Cir. 1999) 27

Hantzis v. Commissioner,
638 F.2d 248 (1st Cir. 1981) 12

Hemelt v. United States,
122 F.3d 204 (4th Cir. 1997) 27

Henderson v. Commissioner,
143 F.3d 497 (9th Cir. 1998) 12
Kornhauser v. United States,
276 U.S. 145 (1928) 25
Lebron v. National R.R. Passenger Corp.,
513 U.S. 374 (1995) 6
Lundy, Commissioner v.,
516 U.S. 235 (1996) 24
Malat v. Riddell,
383 U.S. 569 (1966) 9
Mapp v. Ohio,
367 U.S. 643 (1961) 7
McKay v. Commissioner,
102 T.C. 465 (1994) ..... passim
84 F.3d 433 (5th Cir. 1996) 10
O'Malley v. Commissioner,
91 T.C. 352 (1988) 11, 13
Primuth v. Commissioner,
54 T.C. 374 (1970) 11, 13
Quaratino v. Tiffany & Co.,
166 F.3d 422 (2d Cir. 1999) 20
Rosenspan v. United States,
438 F.2d 905 (2d Cir. 1971) 12
Sinyard v. Commissioner,
268 F.3d 756 (9th Cir. 2001) 19
Soliman, Commissioner v.,
506 U.S. 168 (1993) 9
Spina v. Forest Preserve District of Cook County,
207 F. Supp. 2d 764 (N.D. Ill. 2002) 21
2002 WL 1770010 (N.D. Ill. 2002) 21
Srivastava v. Commissioner,
220 F.3d 353 (5th Cir. 2000) 20
Stidger, Commissioner v.,
386 U.S. 287 (1967) 12, 13, 25

Teague v. Lane,
489 U.S. 288 (1989) 7
Yee v. Escondido,
503 U.S. 519 (1992) 7

1939 INTERNAL REVENUE CODE, 26 U.S.C.

§ 26(a)(1)(A) 12

CURRENT INTERNAL REVENUE CODE, 26 U.S.C.

§ 55(a) 22
§ 55(b)(1)(A)(i) 21
§ 55(d)(1)(B) 21
§ 55(d)(3)(B) 21
§ 56(b)(1)(A)(i) 16, 17
§ 61(a) 2, 5
§ 62(a)(1) ..... passim
§ 62(a)(2)(A) ..... passim
§ 62(c)(1) ..... passim
§ 62(c)(2) ..... passim
§ 63(b) 16
§ 63(d) 16
§ 63(e) 16
§ 67(a) 16, 17
§ 67(b) 16
§ 68 16
§ 162(a) ..... passim
§ 3111(a) 26
§ 3111(b) 26
§ 3121(b) 26
§ 3401(a) 26

TREASURY REGULATIONS, 26 C.F.R.

§ 1.62-2(b) 8, 26
§ 1.62-2(c)(1) 8, 10
§ 1.62-2(c)(2)(i) 6
§ 1.62-2(c)(4) ..... passim
§ 1.62-2(d)(1) 8, 26
§ 1.62-2(e)(1) 8
§ 1.62-2(e)(3) 14
§ 1.62-2(f)(1) 8, 15

OTHER STATUTES, 42 U.S.C.

42 U.S.C. § 1981 9
42 U.S.C. § 1983 9
42 U.S.C. § 1988(b) 20
42 U.S.C. § 2000a-3(b) 20
42 U.S.C. § 2000e et seq. 9
42 U.S.C. § 2000e-5(k) 20
42 U.S.C. § 12205 20

LEGISLATION

Family Support Act of 1988,
Pub. L. No. 100-485, 102 Stat. 2343, 2426 29
Tax Reform Act of 1986,
Pub. L. No. 99-514, 100 Stat. 2085 (1986) 17
Technical and Miscellaneous Revenue Act of 1988,
Pub. L. No. 100-647, 102 Stat. 3342 28

LEGISLATIVE HISTORY

H.R. Conf. Rep. No. 100-998 (1988) 17, 28, 29
S. Rep. No. 100-445 (1988). 28
Staff of the Joint Comm. on Taxation, 99th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986* (Comm. Print 1987) 17, 18, 27

OTHER AUTHORITIES

Carroll, Lewis, Through the Looking Glass (1872) 25
Lathrope, Daniel J., The Alternative Minimum Tax: Compliance and Planning with Analysis (1994) 19
Liptak, Adam, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, The New York Times, August 11, 2002 21
National Taxpayer Advocate, FY 2002 Annual Report to Congress (2002) 20
The Oxford English Dictionary, Second Edition (1989) 9
Webster's Third New International Dictionary of the English Language, Unabridged (2002) 9

INTEREST AND IDENTITY OF *AMICUS*[1]

This *Amicus* brief offers a new argument concerning the question presented, which has not been raised by the parties or considered by the courts below.

Amicus is a scholar and teacher, who is co-author of a series of articles on the federal income tax treatment of attorneys' fees.[2] He is currently a Professor of Law at Georgetown University Law Center in Washington, D.C., where he has taught federal income taxation for the past twenty-five years. He has also taught taxation at Harvard, Rutgers, Stanford, and Wisconsin Law Schools. Except for his academic interests, he has no interest in the outcome of these cases.

Amicus believes that the government's position produces unnecessarily harsh results, which Congress never intended. He therefore respectfully asks this Court to consider his brief in support of the taxpayers.

---

[1] This brief is submitted with the parties' written consent, copies of which have been filed with the Clerk. Pursuant to Rule 37.6, *Amicus* affirms that no counsel for any party authorized this brief in whole or in part. The cost of printing will be reimbursed by Georgetown University Law Center, where *Amicus* is a faculty member. Otherwise only *Amicus* has made a monetary contribution for the preparation and submission of this brief.

[2] Stephen Cohen and Laura Sager, *Final(?) Thoughts on the Biehl Decision*, 99 Tax Notes 133 (2003); "*Judicial Activism*" *Should Not Prolong the Attorney's Fee Problem*, 98 Tax Notes 377 (2003); *Kafka at the Tax Court*, 96 Tax Notes 1503 (2002); *How the Income Tax Undermines Civil Rights Law*, 73 Southern California Law Review 1075 (2000).

SUMMARY OF ARGUMENT

The question presented in *Commissioner v. Banks*, No. 03-892, and *Commissioner v. Banaitis*, No. 03-907, is whether a taxpayer's gross income under Internal Revenue Code § 61(a), 26 U.S.C. § 61(a), includes or excludes the portion of the taxpayer's recovery paid to the taxpayer's attorneys in employment litigation. The answer determines whether Mr. Banks and Mr. Banaitis are taxed, under the Alternative Minimum Tax, on an artificially large amount, namely the total recovery, without any allowance for the attorneys' fees. The answer also determines whether the government will be permitted to interpret the Internal Revenue Code to undermine federal civil rights statutes that prohibit employment discrimination.

The opinions and briefs below assumed that the answer to the question presented depends solely on arguments involving the assignment of income doctrine. This *Amicus* brief offers an entirely different argument: that the taxpayers' gross income excludes the amount paid to their attorneys because that amount satisfies the requirements of Internal Revenue Code § 62(a)(2)(A), 26 U.S.C. § 62(a)(2)(A), for a reimbursed business expense of an employee. Treasury Regulation § 1.62-2(c)(4), 26 C.F.R. § 1.62-2(c)(4), provides that such reimbursed employee business expenses are excluded from gross income. The Court has in the past decided cases on grounds raised only by an *Amicus* and therefore may consider § 62(a)(2)(A), even though this provision was not previously raised or considered in these cases.[3]

For reasons explained in detail in the Argument below, the expenses for the attorneys' fees satisfy the requirements

[3] The Appendix contains the relevant parts of the texts of Internal Revenue Code § 62(a) and Treasury Regulation § 1.62-2.

of the plain language of § 62(a)(2)(A) and the regulations thereunder. Moreover, applying § 62(a)(2)(A) to these expenses is entirely consistent with the congressional purpose of excluding from gross income employee business expenses that do not provide significant personal consumption benefits. Employees, such as Mr. Banks and Mr. Banaitis, do not sue their employers for amusement or recreation.

In principle, it is clear that under an income tax, Mr. Banks and Mr. Banaitis should be taxed only on the net recovery, after an allowance for the attorneys' fees, which are the cost of generating the recovery. What is right in principle should apply in practice with particular force to the Alternative Minimum Tax, which has the objective of providing a more accurate measure of a taxpayer's income than the regular tax.

The government's position—that the Alternative Minimum Tax applies to the entire recovery without any allowance for the attorneys' fees—undermines federal civil rights statutes prohibiting discrimination in employment. These statutes contain fee-shifting provisions, which entitle the prevailing plaintiff in civil rights litigation to recover reasonable attorneys' fees from the defendant. The fee-shifting provisions enable the civil rights plaintiff who cannot pay an attorney, and whose potential recovery is not sufficient for a contingency fee arrangement, to sue for relief. However, if the plaintiff's gross income includes the entire recovery, without any allowance for the attorneys' fees, then the "successful" civil rights plaintiff may retain little or none of the damages after paying taxes and, in some cases, may even suffer a net loss. The government's position therefore frustrates the objective of the fee-shifting provisions, which is to encourage the private enforcement of federal civil rights laws.

The Ninth Circuit's decision in *Biehl v. Commissioner*, 351 F.3d 982 (9th Cir. 2003), that § 62(a)(2)(A) can never apply to the expenses of a former employee, should be rejected. The Ninth Circuit ignored the rule that identical words used in different parts of the same statute are presumed to have the same meaning, misinterpreted Treasury regulations, and misread the legislative history. The Ninth Circuit also made no attempt to harmonize the Internal Revenue Code with federal civil rights statutes, did not consider § 62(a)(2)(A)'s purpose, and ignored the admonition that Congress cannot anticipate every problem that may arise.

For these reasons, *Amicus* respectfully asks this Court to hold that the attorneys' fees in these cases qualify as reimbursed employee business expenses under § 62(a)(2)(A) and thus are excludable from gross income under Treasury Regulation § 1.62-2(c)(4).

ARGUMENT

I. This *Amicus* Brief Presents a New Argument for Excluding the Attorneys' Fees from Taxpayers' Gross Income.

In *Commissioner v. Banks*, No. 03-892, the taxpayer received $464,000 in settlement of an employment discrimination lawsuit, of which he paid $150,000 to his attorney, retaining $314,000 for himself. *Banks v. Commissioner*, 345 F.3d 373, 376 (6th Cir. 2003). In *Commissioner v. Banaitis*, No. 03-907, the taxpayer settled an unlawful-termination-of-employment lawsuit for $8,728,559, of which $3,864,012 was paid directly to his attorney, while the taxpayer received $4,864,547. *Banaitis v. Commissioner*, 340 F.3d 1074, 1078 (9th Cir. 2003).

The question presented in these cases is whether the taxpayers' gross income under Internal Revenue Code § 61(a), 26 U.S.C. § 61(a) includes or excludes the portion of the taxpayers' recovery paid as attorneys' fees. The answer determines whether, under the Alternative Minimum Tax, Mr. Banks and Mr. Banaitis are to be taxed on an artificially large amount, namely the entire recovery, without any allowance for the attorneys' fees, which are the cost of generating the recovery. The answer has special significance because it also determines whether the government will be permitted to interpret the Internal Revenue Code to undermine federal civil rights statutes that prohibit employment discrimination.

The opinions and briefs below assumed that the answer to the question presented depends solely on arguments involving the assignment of income doctrine. *See Banks*, 345 F.3d at 382-86; *Banaitis*, 340 F.3d at 1081-83. This *Amicus* brief presents an entirely different argument, which

was not raised by the parties or considered by the courts of appeals below: that the taxpayers' gross income excludes the portion of the recovery paid to their attorneys because that amount satisfies the requirements of Internal Revenue Code § 62(a)(2)(A), 26 U.S.C. § 62(a)(2)(A), as a reimbursed business expense of an employee.

A. Gross Income Does not Include Amounts that Qualify under Internal Revenue Code § 62(a)(2)(A) as Reimbursed Employee Business Expenses.

Treasury Regulation § 1.62-2(c)(4), 26 C.F.R. § 1.62-2(c)(4) provides that gross income does not include any amount that qualifies under § 62(a)(2)(A) as a reimbursed employee business expense. The regulation states that "[a]mounts treated as paid under an accountable plan are excluded from the employee's gross income." *Id.* An "accountable plan" is defined by Treasury Regulation § 1.62-2(c)(2)(i), 26 C.F.R. § 1.62-2(c)(2)(i), as an arrangement that meets the requirements of § 62(a)(2)(A).[4]

B. The Court May Consider an Argument Raised for the First Time in an *Amicus* Brief.

In *Lebron v. National R.R. Passenger Corp.*, 513 U.S. 374 (1995), this Court observed that "[o]nce a federal claim is properly presented, a party can make any argument in support of that claim; parties are not limited to the precise arguments they made below." 513 U.S. at 378-79. *See*

[4] Under Treasury Regulation § 1.62-2(c)(2)(i), an "accountable plan" is "an arrangement [that] meets the requirements of paragraphs (d), (e), and (f)" of Treasury Regulation § 1.62-2. As explained in Part II of this Argument, *infra* page 8, paragraphs (d), (e), and (f) of Treasury Regulation § 1.62-2 mirror the requirements of § 62(a)(2)(A).

also Yee v. Escondido, 503 U.S. 519, 534 (1992); *Dewey v. Des Moines*, 173 U.S. 193, 198 (1899). This observation applies to an *Amicus* as well, as the Court has in the past decided claims on grounds raised only in an *Amicus* brief. *Teague v. Lane*, 489 U.S. 288, 300 (1989); *Mapp v. Ohio*, 367 U.S. 643, 646, n.3 (1961). Thus, the Court may consider the applicability of § 62(a)(2)(A) even though this provision was not previously raised or considered in these cases.

II. The Attorneys' Fees Satisfy the Plain Language Requirements of § 62(a)(2)(A).

Section 62(a)(2)(A) provides that to qualify as a reimbursed employee business expense, the expense must be "paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer." Internal Revenue Code §§ 62(c)(1) and 62(c)(2), 26 U.S.C. §§ 62(c)(1), 62(c)(2), further define "reimbursement or other expense allowance arrangement" for the purposes of § 62(a)(2)(A). Under § 62(c)(1), the arrangement must "require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement." Under § 62(c)(2), the arrangement must not provide "the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement."

The plain language of §§ 62(a)(2)(A), 62(c)(1), and 62(c)(2) therefore imposes four requirements in order for a reimbursed employee business expense to qualify for exclusion from gross income. First, the expense must be paid or incurred "under a reimbursement or other expense allowance arrangement with [the taxpayer's] employer." § 62(a)(2)(A). Second, the expense must be paid or

incurred "in connection with the performance by [the taxpayer] of services as an employee." § 62(a)(2)(A). Third, the arrangement must "require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement." § 62(c)(1). Fourth, the arrangement must not provide "the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement." § 62(c)(2).

Treasury regulations mirror the four requirements imposed by the plain language of the statute. Treasury Regulation § 1.62-2(b), 26 C.F.R. § 1.62-2(b), requires "a reimbursement or other expense allowance arrangement." Treasury Regulation § 1.62-2(c)(1), 26 C.F.R. § 1.62-2(c)(1), defines a reimbursement or other expense allowance arrangement as "an arrangement that meets the requirements of paragraphs (d) (business connection), (e) (substantiation), and (f) (returning amounts in excess of expenses)." Treasury Regulation § 1.62-2(d)(1), 26 C.F.R. § 1.62-2(d)(1), requires that the expense be "paid or incurred by the employee, in connection with the performance of services as an employee of the employer." Treasury Regulation § 1.62-2(e)(1), 26 C.F.R. § 1.62-2(e)(1), requires "each business expense to be substantiated to the payor." Treasury Regulation § 1.62-2(f)(1), 26 C.F.R. § 1.62-2(f)(1), requires "the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the expenses substantiated."

A. The Settlement Agreements Qualify as Reimbursement Arrangements.

In both *Banks* and *Banaitis*, the settlement agreements were intended and understood by the taxpayers and their employers not only to compensate the taxpayers for the

damages suffered, but also to reimburse the taxpayers for their attorneys' fees. In *Banks*, the settlement agreement specified that the parties were settling all of the plaintiff's claims, *Banks*, 345 F.3d at 376, one of which was for attorneys' fees under the fee-shifting provisions of 42 U.S.C. §§ 1981 and 1983 and Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e et seq. *Banks*, 345 F.3d at 375-76. The employer made out a single check payable to the taxpayer, who then paid the attorneys' fees from the settlement amount. *Id.* at 376. In *Banaitis*, under the terms of the settlement agreement, the employer made out two separate checks, one payable to the taxpayer for the amount of damages, the other payable to the taxpayer's attorneys for the amount of their fees for legal services. *Banaitis*, 340 F.3d at 1078.

When a term in the Internal Revenue Code, such as "arrangement," is not specially defined, the rule is that the term should be given its ordinary, everyday meaning. *Commissioner v. Soliman*, 506 U.S. 168, 173 (1993); *Malat v. Riddell*, 383 U.S. 569, 571 (1966). One of the ordinary, everyday dictionary definitions of the word "arrangement" is a settlement or agreement. The Oxford English Dictionary includes among the definitions of arrangement "[a] settlement of mutual relations or claims between parties; an adjustment of disputed or debatable matters; a settlement by agreement." The Oxford English Dictionary, Second Edition 645 (1989). Webster's Third New International Dictionary of the English Language defines an arrangement, among other things, as "a settlement or adjustment esp. [especially] of a dispute or claim." Webster's Third New International Dictionary of the English Language, Unabridged 120 (2002).

The language of § 62(a)(2)(A) and of the regulations thereunder contains no special requirements for or

definition of an "arrangement" beyond the in-connection-with-the-performance-of-services-as-an-employee language of § 62(a)(2)(A) and the substantiation and no-retention-of excess-reimbursement-amount provisions of §§ 62(c)(1) and 62(c)(2). Indeed, Treasury Regulations explicitly confirm that there are no special extra-statutory requirements for a "reimbursement or other expense allowance arrangement." As noted above, Treasury Regulation § 1.62-2(c)(1) defines a reimbursement or other expense allowance arrangement simply as "an arrangement that meets the requirements of paragraphs (d) (business connection), (e) (substantiation), and (f) (returning amounts in excess of expenses)." Therefore, the settlements in *Banks* and *Banaitis*, under which the employers agreed to reimburse the expenses incurred by the taxpayers for their attorneys' fees, should qualify as reimbursement arrangements under § 62(a)(2)(A) provided that the taxpayers satisfy these three requirements.

B. The Fees Arose in Connection with the Performance of Services by the Taxpayers as Employees.

It is well settled that the expenses of a former employee in prosecuting a wrongful-termination-of-employment claim qualify under Internal Revenue Code § 162(a), 26 U.S.C. § 162(a), as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on" the trade or business of an employee. *Alexander v. Commissioner*, 72 F.3d 938, 945 (1st Cir. 1995); *Biehl v. Commissioner*, 118 T.C. 467, 477 (2002), *aff'd*, 351 F.3d 982 (9th Cir. 2003); *McKay v. Commissioner*, 102 T.C. 465, 489 (1994), vacated and remanded on another issue, 84 F.3d 433 (5th Cir. 1996)

(unreported decision).[5] Thus, the attorneys' fees, which were the expenses of prosecuting the wrongful-termination-of-employment claims in both *Banks* and *Banaitis*, constitute "ordinary and necessary expenses paid or incurred during the taxable year in carrying on" the business of an employee under § 162(a).

Moreover, the business of an employee (as opposed to a self-employed taxpayer) is defined as the performance of services as an employee, and this definition applies whether or not the taxpayer is currently employed. *Alexander*, 72 F.3d at 945 and n.13; *McKay*, 102 T.C. at 488; *O'Malley v. Commissioner*, 91 T.C. 352, 363-64 (1988); *Primuth v. Commissioner*, 54 T.C. 374, 377 (1970). This definition is incorporated, for example, in Internal Revenue Code § 62(a)(1), 26 U.S.C. § 62(a)(1), which defines a nonemployee business by what it is not, that is, a business that "does not consist of the performance of services by the taxpayer as an employee."[6] Thus, because the expenses for the attorneys' fees in these cases were incurred in carrying on the business of an employee under § 162(a), and because the business of an employee is defined as the performance

---

[5] Although the government at one time took a contrary position, *McKay*, 102 T.C. at 488-89, it has now conceded this point. *Biehl*, 351 F.3d at 984.

[6] In *Alexander*, the First Circuit construed the performance-of-services-as-an-employee language in § 62(a)(1) to include former as well as current employees. 72 F.3d at 944-45. In *Biehl v. Commissioner*, 351 F.3d 982 (9th Cir. 2003), the Ninth Circuit acknowledged the First Circuit's construction of this language in § 62(a)(1) as including former as well as current employees and did not dispute that construction. 351 F.3d at 987. Nevertheless the Ninth Circuit held that virtually identical language in § 62(a)(2)(A) could never include a former employee. *Id.* at 986. Part V of this Argument, *infra*, explains why the Ninth Circuit's decision in *Biehl* should be rejected.

of services as an employee, the expenses were incurred in carrying on the business of the performance of services as an employee.

Over half a century ago, the Supreme Court construed the words "in carrying on" under the predecessor of § 162(a) to mean "that there must be a direct connection between the expenditure and the carrying on of the trade or business of the taxpayer." *Commissioner v. Flowers*, 326 U.S. 465, 470 (1946).[7] Since *Flowers*, the touchstone of the inquiry into whether an expense is paid or incurred "in carrying on" a business under § 162(a) has been whether there is a sufficient business connection. *Commissioner v. Stidger*, 386 U.S. 287, 289-90 (1967); *Henderson v. Commissioner*, 143 F.3d 497, 499-501 (9th Cir. 1998); *Hantzis v. Commissioner*, 638 F.2d 248, 250, 252, 254-55 (1st Cir. 1981); *Rosenspan v. United States*, 438 F.2d 905, 909 (citing *Flowers*), 910 (citing *Stidger*) (2d Cir. 1971). Because the attorneys' fees in these cases were expenses incurred "in carrying on" the business of the performance of services as an employee under § 162(a), the expenses necessarily had a "direct connection" with that business under *Flowers*, 326 U.S. at 470, and were therefore "in connection with the performance by [the taxpayer] of services as an employee," as required by § 62(a)(2)(A).

To recapitulate, it is well settled that the attorneys' fees in these cases were expenses incurred "in carrying on" the business of an employee under § 162(a). *Alexander*, 72 F.3d at 945; *Biehl*, 118 T.C. at 477; *McKay*, 102 T.C. at 489. Moreover, the business of an employee is defined as

[7] The predecessor of current § 162(a) was § 26(a)(1)(A) of the 1939 Internal Revenue Code, 26 U.S.C. § 26(a)(1)(A) (1939). Both provisions, using identical language, refer to "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

the performance of services as an employee, whether or not the taxpayer is currently employed. *Alexander*, 72 F.3d at 945 and n.13; *McKay*, 102 T.C. at 488; *O'Malley v. Commissioner*, 91 T.C. 352, 363-64 (1988); *Primuth v. Commissioner*, 54 T.C. 374, 377 (1970). Therefore, the attorneys' fees were expenses incurred in carrying on the performance of services as an employee. In addition, since the courts have defined "in carrying on" as meaning a "direct connection," *Flowers*, 326 U.S. at 470; *Stidger*, 386 U.S. at 289-90, it follows that the expenses for the attorneys' fees were paid or incurred "in connection with" the performance of services as an employee under § 62(a)(2)(A)—unless some reason compels a construction of the phrase "in connection with" in § 62(a)(2)(A) that means something very different from the "direct connection" required by this Court's construction of § 162(a).

To the contrary, construing the "in connection with" language of § 62(a)(2)(A) as satisfied whenever an expense is paid or incurred "in carrying on" the business of the performance of services as an employee under § 162(a) comports with the sorting function that § 62(a)(2)(A) performs in conjunction with § 62(a)(1). Section 62(a)(1) applies to all business expenses except those attributable to the business "of the performance of services by the taxpayer as an employee." In other words, § 62(a)(1) applies to all nonemployee business expenses.

Employee business expenses, on the other hand, are governed by § 62(a)(2)(A), which is satisfied for expenses "in connection with the performance of services by [the taxpayer] as an employee," provided that the employee expenses are paid or incurred under a reimbursement arrangement, which is defined as an arrangement that meets the substantiation and no-retention-of-excess-

reimbursement-amount requirements of §§ 62(c)(1) and 62(c)(2). The "in connection with" language of § 62(a)(2)(A) therefore, operates as a sorting device, ensuring that all employee business expenses are tested by the reimbursement arrangement that meets the substantiation and no-retention-of-excess-reimbursement-amount requirements of §§ 62(c)(1) and 62(c)(2), while nonemployee business expenses—those falling under § 62(a)(1)—are not subject to such requirements.

C. The Fee Amounts Were Substantiated, and the Taxpayers Did Not Retain Excess Reimbursement Amounts.

The substantiation and no-retention-of-excess reimbursement amount requirements of §§ 62(c)(1) and 62(c)(2) are clearly satisfied by the facts of *Banks* and *Banaitis*. The amount of the attorneys' fees is substantiated in each case by reference to the contingency fee agreement and the total settlement amount. *Banks*, 345 F.3d at 376; *Banaitis*, 340 F.3d at 1078.[8]

Moreover, in neither case did the taxpayer retain any of the amount paid by the employer to reimburse the expense for the attorney's fee. *Id.* In *Banks*, although the attorneys' fees were paid by the plaintiff out of the proceeds of a

[8] Under § 62(c)(1), the reimbursement arrangement must "require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement." Read literally, § 62(c)(1) only states that the reimbursement arrangement must impose a substantiation requirement but does not state that the employee must actually comply with that requirement. Treasury Regulation § 1.62-2(e)(3), 26 C.F.R. § 1.62-2(e)(3), takes a more practical approach, focusing on whether substantiation is in fact provided rather than on whether the arrangement requires substantiation. *Brenner v. Commissioner*, T.C. Memo 2001-127.

single settlement check, it is undisputed that the taxpayer paid the full amount required by the contingency fee agreement to his attorneys. 345 F.3d at 376. In *Banaitis*, it would have been impossible for the taxpayer to retain any excess since the portion of the settlement amount that was allocated to the attorneys' fees was paid directly to the attorney. 340 F.3d at 1078.[9]

Thus, the expenses for the attorneys' fees in both *Banks* and *Banaitis* satisfy the requirements of §§ 62(a)(2)(A), 62(c)(1), and 62(c)(2) and the regulations thereunder. Pursuant to Treasury Regulation § 1.62-2(c)(4), the portion of the recovery paid to the attorneys should be excluded from the taxpayers' gross income.

III. Applying § 62(a)(2)(A) Is Consistent with the Statute's Purpose of Excluding from Taxation Business Expenses that Do Not Provide Personal Consumption Benefits.

The Internal Revenue Code sharply distinguishes between employee business expenses that qualify as reimbursed under § 62(a)(2)(A) and employee business expenses that do not. Reimbursed employee business

[9] Under § 62(c)(2), the reimbursement arrangement must not allow "the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement." The regulations interpret § 62(c)(2) to mean something more than a prohibition; the reimbursement arrangement must affirmatively require "the employee to return to the payor" any excess amount. Treas. Reg. § 1.62-2(f)(1). This command, however, is further modified by the statement that "whether an arrangement requires an employee to return amounts in excess of substantiated expenses will depend on the facts and circumstances." Treas. Reg. § 1.62-2(f)(1). Under the practical "facts and circumstances" test of Treasury Regulation § 1.62-2(f)(1), the requirements of § 62(c)(2) are satisfied in both *Banks* and *Banaitis*.

expenses are excluded from gross income pursuant to Treasury Regulation § 1.62-2(c)(4). Unreimbursed employee business expenses, on the other hand, are subject to important disadvantages.

Although includible in gross income, such unreimbursed employee business expenses are: (1) deductible only if the taxpayer does not elect the standard deduction; (2) deductible only to the extent that they and other specified expenses exceed two percent of adjusted gross income; (3) subject to a phase-out once adjusted gross income exceeds a specified level; and (4) most significant for the taxpayers in *Banks* and *Banaitis*, not deductible at all under the Alternative Minimum Tax.[10]

According to the legislative history, there are two reasons why Congress decided to subject unreimbursed employee business expenses to these serious disadvantages. First, Congress was concerned that such expenses provide

[10] Employee business expenses that do not satisfy §§ 62(a)(2)(A), 62(c)(1), and 62(c)(2) are not deductible in computing adjusted gross income. § 62(a)(2)(A). Expenses that are not deductible in computing adjusted gross income are "itemized deductions." Internal Revenue Code § 63(d), 26 U.S.C. § 63(d). Itemized deductions are also "miscellaneous itemized deductions" unless specially exempted, and unreimbursed employee business expenses are not among the exempted items. Internal Revenue Code § 67(b), 26 U.S.C. § 67(b). Miscellaneous itemized deductions are (1) deductible only if the taxpayer does not elect the standard deduction, Internal Revenue Code §§ 63(b) and 63(e), 26 U.S.C. §§ 63(b), 63(e); (2) deductible only to the extent that the aggregate amount of such deductions exceeds two percent of adjusted gross income, Internal Revenue Code § 67(a), 26 U.S.C. § 67(a); (3) subject to a phase-out (along with most other itemized deductions) once adjusted gross income exceeds a specified amount, Internal Revenue Code § 68, 26 U.S.C. § 68; and (4) not deductible at all under the Alternative Minimum Tax. Internal Revenue Code § 56(b)(1)(A)(i), 26 U.S.C. § 56(b)(1)(A)(i).

taxpayers with significant personal consumption benefits, which in principle should be taxed. The Joint Committee on Taxation explained that employee business expenses that do not satisfy § 62(a)(2)(A) "have characteristics of voluntary personal expenditures" and may "convey personal and recreational benefits" to the employee. Staff of the Joint Comm. on Taxation, 99th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 78-79 (Comm. Print 1987).[11] The 1988 Conference Committee Report accompanying the enactment of §§ 62(c)(1) and 62(c)(2) noted that "some unreimbursed expenses that an employee chooses to incur are sufficiently personal in nature that they would be incurred apart from the taxpayer's performance of services as an employee . . . ." H.R. Conf. Rep. No. 100-998, at 202 (1988).

This first reason is also reflected in the language of § 62(c)(2), which prohibits the employee from retaining reimbursement amounts in excess of substantiated expenses. The objective is to prevent taxpayers from excluding from gross income excess cash reimbursement

[11] The quoted passages explain the justification for § 67(a), which limits the regular tax deduction for unreimbursed employee business expenses, to the extent that they and other specified expenses exceed two percent of adjusted gross income. Neither the Joint Committee on Taxation, nor the House and Senate reports explained the justification for § 56(b)(1)(A)(i), which subjects such items to the Alternative Minimum Tax. Staff of the Joint Comm. on Taxation., 99th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 78-79 (Comm. Print 1987); H.R. CONF. REP. NO. 99-841, pt. 2, at 259-60 (1986); S. REP. NO. 99-313, at 535 (1986). However, it is reasonable to assume that the justification for § 67(a) applies to § 56(b)(1)(A)(i) as well, since both provisions were enacted at the same time as part of the same legislation and since both provisions limit the deduction of employee business expenses that do not satisfy § 62(a)(2)(A). Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

amounts that can be used for personal rather than business purposes.

Second, Congress believed that unreimbursed employee business expenses generally involve small amounts and therefore impose burdensome recordkeeping and enforcement requirements on both taxpayers and the Internal Revenue Service.

> For taxpayers who anticipated claiming [such] deductions, prior law effectively required extensive record keeping with regard to what commonly are small expenditures. Moreover, the fact that small amounts typically were involved presented significant administrative and enforcement problems for the Internal Revenue Service.

Staff of the Joint Comm. on Taxation., 99th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 78 (Comm. Print 1987) (footnote omitted).

Neither reason for the tax disadvantages imposed on unreimbursed employee business expenses applies in these cases. The attorneys' fees that employees, such as Mr. Banks and Mr. Banaitis, incur in suing their former employers obviously are not for amusement or recreation and provide no significant personal consumption benefits. Moreover, the attorneys' fees in these cases are not the kind of relatively small expenditures for meals, entertainments, and the like that present disproportionate recordkeeping and enforcement burdens on taxpayers and the Internal Revenue Service.

The fact is that Congress never intended to include within the category of unreimbursed employee business expenses, subject to full taxation under the Alternative Minimum Tax, the large amount of attorneys' fees that are

incurred in employment litigation and provide no significant personal consumption benefits. Construing § 62(a)(2)(A) to apply to the expenses for attorneys' fees in these cases and excluding such fees from the taxpayers' gross income pursuant to Treasury Regulation § 1.62-2(c)(4) is entirely consistent with the purpose of the statute.

IV. Applying § 62(a)(2)(A) Avoids a Result that Is Grossly Unfair and Irrational and that Undermines Federal Civil Rights Statutes.

As a matter of principle, it is clear that under an income tax, Mr. Banks and Mr. Banaitis should be taxed only on the recovery, net of the attorneys' fees, which are the cost of generating the recovery. No serious economist or lawyer would argue that in *Banks*, the taxpayer's income from the employment litigation was $464,000 rather than the $314,000 net amount that the taxpayer actually retained or, in *Banaitis,* was $8,728,559 rather than the $4,864,547 net amount that the taxpayer actually received. What is right in principle should apply in practice with particular force to the Alternative Minimum Tax, which has the objective of providing a more accurate measure of taxable income than the regular tax. *See* Daniel J. Lathrope, The Alternative Minimum Tax: Compliance and Planning with Analysis, ¶ 1.02, at 1-2 to 1-3 (1994).

Thus, courts have often observed that the government's position on the tax treatment of attorneys' fees in employment litigation is arbitrary, irrational, and unfair because it produces a taxable income figure for purposes of the Alternative Minimum Tax that greatly exceeds the taxpayer's actual income amount. *See, e.g., Alexander*, 72 F.3d at 946; *Banks* 345 F.3d at 385; *Sinyard v. Commissioner,* 268 F.3d 756, 762-63 (9th Cir. 2001)

(Judge McKeown, dissenting); *Srivastava v. Commissioner*, 220 F.3d 353, 363-65 (5th Cir. 2000). Moreover, the National Taxpayer Advocate, an independent office established by Congress, has listed the irrational and unfair treatment of attorneys' fees as one of six major problem areas in the federal income tax. National Taxpayer Advocate, FY 2002 Annual Report to Congress, 156, 160-62 (2002).

The government's position in *Banks* and *Banaitis* produces especially harsh results when a plaintiff sues for employment discrimination under federal civil rights statutes. In civil rights cases, the plaintiff's damages are often too modest to enable the plaintiff to obtain representation under a contingency fee agreement that promises the attorney a percentage of the damages. *City of Riverside v. Rivera*, 477 U.S. 561, 577 (1986) (plurality opinion). Therefore, Congress has provided for the prevailing plaintiff in civil rights litigation to recover not only damages, but also a reasonable amount to pay for the services of the plaintiff's attorneys. 42 U.S.C. § 1988(b) (Civil Rights Attorney's Fees Awards Act of 1976); 42 U.S.C. § 2000a-3(b) (Civil Rights Act of 1964); 42 U.S.C. § 2000e-5(k) (Civil Rights Act of 1964); 42 U.S.C. § 12205 (Americans with Disabilities Act of 1990). The potential attorneys' fees award enables the civil rights plaintiff whose damages are not sufficient for a contingency fee agreement to obtain representation. *City of Riverside*, 477 U.S. at 576-79; *Quaratino v. Tiffany & Co.*, 166 F.3d 422, 426 (2d Cir. 1999).

When the damages for employment discrimination are modest compared to the attorneys' fees, the government's position will result in the civil rights plaintiff retaining little or none of the damages after paying taxes on the gross recovery, which includes the attorneys' fees as well as the

damages. In some cases, the "successful" plaintiff may even suffer a net loss because the tax liability will exceed the damages received.

A New York Times article provides a striking example of such a case. Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, The New York Times, August 11, 2002, p. 18. The article discusses *Spina v. Forest Preserve District of Cook County*, 207 F. Supp. 2d 764 (N.D. Ill. 2002). In *Spina*, a police officer who sued her employer for sex discrimination, including sexual harassment, in violation of Title VII of the 1964 Civil Rights Act, was awarded $300,000 in compensatory damages, 207 F. Supp. 2d at 779, plus $950,000 for her attorneys' fees, *Spina v. Forest Preserve District of Cook County*, 2002 WL 1770010, at *9 (N.D. Ill. 2002). The fee award was especially large because of the extraordinary dilatory and obstructionist tactics of the defendant. *Id.* at *4.

If the government's position in *Banks* and *Banaitis* prevails, the Alternative Minimum Tax will apply to the entire $1,250,000 amount in *Spina*. Assuming that the taxpayer files singly and has no other income or deductions, her Alternative Minimum Tax liability would be about $345,000, or $45,000 more than her compensatory damage award.[12]

---

[12] For a single taxpayer, up to $40,250 of income is exempt from the Alternative Minimum Tax. § 55(d)(1)(B), 26 U.S.C. § 55(d)(1)(B). However, the exemption amount is subject to a phase-out, which in this example reduces that amount to zero. § 55(d)(3)(B), 26 U.S.C. § 55(d)(3)(B). Thus, income above the exemption amount is $1,250,000. The first $175,000 of income above the exemption amount is taxed at a rate of 26%. Any additional income is taxed at a rate of 28%. § 55(b)(1)(A)(i), 26 U.S.C. § 55(b)(1)(A)(i). The tax due on the first $175,000 of income is $45,500. The tax due on the $1,075,000 of additional income is $301,000. Thus, the total tax due under the Alternative Minimum Tax in this example is $346,500, and the net loss

As the facts of *Spina* illustrate, the government's position not only renders illusory the promise of damages for employment discrimination under federal civil rights statutes. It can also have the punitive effect of imposing a net loss on the "successful" plaintiff. If "success" in litigation means not only retaining little, if any, damages after taxes but also incurring a significant risk of a net loss, victims of employment discrimination will be reluctant to sue. The government's position, if adopted, will therefore have the practical effect of negating federal civil rights protections.

The government's position in these cases also ignores the obligation to construe a statute to "foster harmony" with other statutory law. *Digital Equip. Corp. v. Desktop Direct, Inc.*, 511 U.S. 863, 879 (1994). While the government's position undermines federal civil rights statutes, the application of § 62(a)(2)(A) to the expense for the attorneys' fees in these cases would instead foster harmony between the tax law and federal statutes prohibiting discrimination in employment.

V. The Ninth Circuit's Decision that § 62(a)(2)(A) Cannot Apply to a Former Employee Should Be Rejected.

Only one Court of Appeals decision has discussed in detail the question of whether § 62(a)(2)(A) applies to the portion of a settlement devoted to attorneys' fees in employment litigation.[13] In *Biehl v. Commissioner*, 351

to the prevailing plaintiff is nearly $46,500. The taxpayer must pay the amount owed under either the regular tax or the Alternative Minimum Tax, whichever is higher. Internal Revenue Code § 55(a), 26 U.S.C. § 55(a).

[13] In *Alexander*, 72 F.3d 938, the First Circuit briefly considered but did not discuss whether § 62(a)(2)(A) might apply to the portion of a

F.3d 982 (9th Cir. 2003), the Ninth Circuit held that § 62(a)(2)(A) does not apply to expenses incurred by a former employee because Congress's "use of the words 'performance' and 'employee' dictates that . . . the reimbursed expenses must be incurred during the course of employment." 351 F.3d at 986. In addition, the court indicated that in order to qualify under § 62(a)(2)(A), the employee must act "on behalf of the employer" when incurring the expense. *Id.* at 987. However, the Ninth Circuit's interpretation of § 62(a)(2)(A) should be rejected because it conflicts with the First Circuit's construction of virtually identical language in the adjacent Internal Revenue Code provision, § 62(a)(1) and is based on a misreading of the statute, the regulations, and the legislative history.

A. The Ninth Circuit Ignored the Rule that Identical Words in the Same Statute Are Presumed to Have the Same Meaning.

Section 62(a)(2)(A) contains the phrase, "the performance by him [i.e., the taxpayer] of services as an employee." Virtually identical language in § 62(a)(1) refers to "the performance of services by the taxpayer as an employee." It is a "normal rule of statutory

taxpayer's recovery paid to his attorney in employment litigation. Although the First Circuit held that § 62(a)(2)(A) could not apply to the case before it, the basis for its conclusion was not entirely clear. It appears that the First Circuit was concerned that the settlement agreement did not constitute a "reimbursement or other expense allowance arrangement" under § 62(a)(2)(A) either because the employer had not intended to reimburse the expense or because the expense amount was not adequately substantiated. The First Circuit noted that "the settlement agreement itself makes no mention of attorney's fees," 72 F.3d at 946, and cited the substantiation requirement, *id.*, n. 17.

construction . . . that identical words used in different parts of the same act are intended to have the same meaning." *Commissioner v. Lundy*, 516 U.S. 235, 250 (1996) (citation and internal quotation marks omitted).

In *Alexander v. Commissioner*, 72 F.3d 938 (1st Cir. 1995), the First Circuit construed the performance-of-services-as-an-employee language of § 62(a)(1) to include former as well as current employees. 72 F.3d at 944-45. As the First Circuit noted, "no distinction is made in § 62(a)(1) between present and former employees if the expenses originated in the trade or business of being an employee." *Id.* at 945.

Section 62(a)(2)(A) contains language that is virtually identical to § 62(a)(1) and, like the preceding subsection, makes no distinction between present and former employees. In *Biehl*, the Ninth Circuit acknowledged the First Circuit's construction of the performance-of-services-as-an-employee language in § 62(a)(1) as including former as well as current employees and did not dispute that construction. Nevertheless, the Ninth Circuit held that the performance-of-services-as-an-employee language in § 62(a)(2)(A) could never apply to a former employee. 351 F.3d at 987.

The Ninth Circuit justified ascribing different meanings to virtually identical language on the ground that § 62(a)(1) requires only that the expense be "attributable to a trade or business" while under § 62(a)(2)(A) the expense must also have been incurred "during the course of 'performance of services as an employee.' IRC § 62(a)(2)(A)." *Id.* at 986. However, the words "during the course of" do not appear in the statute. Rather, the statute says that the expense must have been incurred "in connection with the performance by [the taxpayer] of services as an employee." § 62(a)(2)(A) (emphasis added).

Furthermore, any assertion that a former employee's expense of prosecuting a wrongful-termination-of-employment claim might be "attributable to" under § 62(a)(1) but not "in connection with" under § 62(a)(2)(A) is without merit. In *Alexander*, the First Circuit held that such an expense was "attributable to" the business of the performance of services by the taxpayer as an employee under § 62(a)(1) because the "[t]axpayer's lawsuit was 'directly connected with, or proximately resulted from' his employment." 72 F.3d at 945 (citing *Kornhauser v. United States*, 276 U.S. 145, 153 (1928)). Moreover, because the expense of prosecuting a wrongful-termination-of-employment claim qualifies under § 162(a) as paid or incurred "in carrying on" the taxpayer's business as an employee, the expense is directly connected with the taxpayer's business as an employee and therefore necessarily arises "in connection with" that business. *See Flowers*, 326 U.S. at 470; *Stidger*, 386 U.S. at 289-90.

The Ninth Circuit's position—that the expenses in these cases, although "attributable to the business of the performance of services by the taxpayer as an employee" under § 62(a)(1), are not "in connection with the performance by [the taxpayer] of services as an employee" under § 62(a)(2)(A)—recalls the exchange between Humpty Dumpty and Alice in Lewis Carroll's Through the Looking Glass:

> "When I use a word," Humpty Dumpty said in rather a scornful tone, "it means just what I choose it to mean—neither more nor less."
>
> "The question is," said Alice, "whether you CAN make words mean so many different things."

Lewis Carroll, Through the Looking Glass, Chapter 6 (1872).

B. The Ninth Circuit Misinterpreted the Regulations.

The Ninth Circuit attempted to buttress its assertion that § 62(a)(2)(A) could never apply to the expenses of a former employee by citing regulations under § 62(a)(2)(A) that refer to an employee "*of the employer*." 351 F.3d at 986 (citing Treas. Reg. §§ 1.62-2(b), (d)(1)) (emphasis in the original). According to the Ninth Circuit, the of-the-employer phrase "reconfirm[s] that the expenses must have been incurred on behalf of the employer within a current employment relationship." 351 F.3d at 987. The court did not, however, explain why a current-employee requirement would be articulated imprecisely and vaguely through the words "of the employer" when the statute and regulations prescribe every other requirement in explicit, detailed language.

The Ninth Circuit also ignored the fact that similar language elsewhere in the Internal Revenue Code applies to former as well as current employees. The Internal Revenue Code, for example, requires an employer to withhold income and social security taxes on wages paid for: (1) "individuals in his employ," §§ 3111(a) and 3111(b), 26 U.S.C. §§ 3111(a), 3111(b); (2) "any service, of whatever nature, performed . . . by an employee for the person employing him," § 3121(b), 26 U.S.C. § 3121(b), 26 U.S.C. § 3121(b); and (3) "services performed by an employee for his employer", § 3401(a), 26 U.S.C. § 3401(a). These provisions have all been construed to mean that a former employer must withhold income and social security taxes on amounts paid to a former employee even if the amounts compensate the employee for wages that would have been earned after the termination of employment, that is, at a time when the employee was no longer a current employee. *Gerbec v. United States*, 164 F.3d 1015, 1026 (6th Cir. 1999); *Hemelt v. United States*, 122 F.3d 204, 210 (4th Cir. 1997). The Ninth Circuit offered no explanation why the words "of the employer" in Treasury regulations exclude former employees when similar phrases in the statute itself (such as "in his employ," "for the person employing him," and "for his employer") include former employees.

C. The Ninth Circuit Misread the Legislative History.

The Ninth Circuit also relied on a misreading of the legislative history to support adding both current-employee and on-behalf-of-the-employer requirements to the express language of § 62(a)(2)(A). The court's initial citation of the legislative history erroneously stated:

> The *General Explanation of the Tax Reform Act of 1986* defines an employee business expense as "a cost incurred by an employee in the course of performing his or her job." Staff of the Joint Comm. on Taxation, 99th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986* 78 (Comm. Print 1987). This strongly suggests that costs incurred after employment has terminated, such as wrongful termination litigation expenses, do not qualify.

351 F.3d at 986-87.[14]

However, the excerpt quoted by the Ninth Circuit refers to § 162(a), not to § 62(a)(2)(A). Staff of the Joint Comm. on Taxation, 99th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986* 76 (Comm.

---

[14] The paragraph occurs on page 76 of the Report, not on page 78 as the Ninth Circuit's opinion indicates.

Print 1987). Therefore, the excerpt does not purport to define expenses that satisfy the requirements of § 62(a)(2)(A), as the court erroneously suggested. Moreover, any suggestion that a former employee cannot have a § 162(a) employee business expense is clearly wrong. As noted above, it is well settled that the costs of a former employee's prosecution of a wrongful termination claim qualify as a trade or business expense under § 162(a). *Alexander*, 72 F.3d at 945; *Biehl*, 118 T.C. at 477, *McKay*, 102 T.C. at 489.

The Ninth Circuit's claim that the legislative history "connotes" an on-behalf-of-the-employer requirement, 351 F.3d 986, is similarly misplaced. First, the court cited a 1988 Senate Report accompanying the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 to support a requirement that the employee act on behalf of the employer when incurring the expense. *Id.* at 987. (citing S. Rep. No. 100-445, at 7 (1988). However, the reference in the Senate Report is not to the employee acting on behalf of the employer but merely to an employer's arranging for a third party to reimburse the employee "on behalf of the employer." S. Rep. No. 100-445, at 7 (1988).[15] The Senate Report did not state that Congress intended to impose an on-behalf-of-the-employer requirement in addition to the other explicit, detailed requirements of the statute.

Second, the court cited references to "the employer's behalf" from a 1988 House Conference Report, 351 F.3d 987 (citing H.R. Conf. Rep. No. 100-998, at 203), which accompanied the enactment of §§ 62(c)(1) and 62(c)(2),

[15] The technical amendment added the last sentence of § 62(a)(2)(A), which permits a reimbursement to be made by a third party rather than by the employer. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, 3349.

Family Support Act of 1988, Pub. L. No. 100-485, 102 Stat. 2343, 2426. However, these references should be understood in light of the specific abuse at which §§ 62(c)(1) and 62(c)(2) were aimed, namely, so-called "nonaccountable plans," under which "(1) the employee is not required to substantiate expenses . . . to the person providing reimbursement, or (2) the employee has the right to retain amounts in excess of the substantiated expenses . . . ." H.R. Conf. Rep. No. 100-998, at 201-02.

The references in the House Conference Report to expenses on "the employer's behalf," *id.* at 202-03, were clearly meant to contrast accountable plans, in which the taxpayer must substantiate the expenses and is not permitted to retain excess reimbursement amounts, with nonaccountable plans, in which such requirements are absent. These references do not support a requirement that the employee act on the employer's behalf when incurring the expense in addition to the explicit, detailed substantiation and no-retention-of-excess-reimbursement-amount requirements imposed by §§ 62(c)(1) and 62(c)(2). The Ninth Circuit did not explain why the legislative history of §§ 62(c)(1) and 62(c)(2) "connotes" an on-behalf-of-the-employer requirement, 351 F.3d 986, not contained in the words of the statute, when Congress set out every other requirement in explicit statutory language.

D. The Ninth Circuit Made No Attempt to Harmonize the Internal Revenue Code with Federal Civil Rights Statutes, Consider § 62(a)(2)(A)'s Purpose, or Heed the Admonition that Congress Cannot Anticipate Every Problem that May Arise.

The Ninth Circuit failed to apply other well-established principles of statutory construction. It did not consider

§ 62(a)(2)(A)'s purpose, which it was obligated to do, since the performance-of-services-as-an-employee language is hardly a model of clarity. *See Adams Fruit Co. v. Barrett*, 494 U.S. 638, 645-47 (1990). The court therefore appears to have forgotten Judge Learned Hand's admonition "to remember that statutes always have some purpose or object to accomplish." *Cabell v. Markham*, 148 F.2d 737, 739 (2d Cir. 1945). Nor did the court attempt to harmonize § 62(a)(2)(A) with other federal statutes, as required by prior Supreme Court decisions. *See Digital Equip. Corp.*, 511 U.S. at 879. Moreover, the court reasoned that § 62(a)(2)(A) never applies to attorneys' fees because Congress did not "anticipate" § 62(a)(2)(A)'s application, 351 F.3d 987, even though, as this Court has held, "Congress cannot be expected to anticipate every conceivable problem that can arise," *Bob Jones University v. United States*, 461 U.S. 574, 597 (1983).

CONCLUSION

For the reasons stated above, *Amicus* respectfully asks this Court to hold that the portion of the taxpayers' recovery in *Banks* and *Banaitis* that is paid as attorneys' fees qualifies as a reimbursed employee expense under Internal Revenue Code § 62(a)(2)(A) and thus is excludable from their gross income pursuant to Treasury Regulation § 1.62-2(c)(4).

RESPECTFULLY SUBMITTED, July 2003
Stephen B. Cohen
Counsel of Record, *Pro Se*
Georgetown University Law Center
600 New Jersey Ave., N.W.
Washington, D.C. 20001
202-352-8244

APPENDIX

I. Internal Revenue Code § 62, 26 U.S.C. § 62

Adjusted Gross Income Defined

(a) General rule

For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(1) Trade and business deductions

The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

(2) Certain trade and business deductions of employees

(A) Reimbursed expenses of employees

The deductions allowed by part VI (section 161 and following) which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer. The fact that the reimbursement may be provided by a third party shall not be

determinative of whether or not the preceding sentence applies.

* * * *

(c) Certain arrangements not treated as reimbursement arrangements

For purposes of subsection (a)(2)(A), an arrangement shall in no event be treated as a reimbursement or other expense allowance arrangement if--

(1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or

(2) such arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

* * * *

II. Treasury Regulation § 1.62-2, 26 C.F.R. § 1.62-2

Reimbursements and other expense allowance arrangements

* * * *

(b) Scope.

For purposes of determining "adjusted gross income," section 62(a)(2)(A) allows an employee a deduction for expenses allowed by part VI (section 161 and following), subchapter B, chapter 1 of the Code, paid by the employee, in connection with the performance of services as an employee of the employer, under a reimbursement or other expense allowance arrangement with a payor (the employer, its agent, or a third party). Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of section 62(a)(2)(A) if--

(1) Such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) Such arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

This section prescribes rules relating to the requirements of section 62(c).

(c) Reimbursement or other expense allowance arrangement-

(1) Defined.

For purposes of Sections 1.62-1, 1.62-1T and 1.62-2, the phrase "reimbursement or other expense allowance arrangement" means an arrangement that meets the requirements of paragraphs (d) (business connection, (e) (substantiation), and (f) (returning amounts in excess of expenses) of this section.

* * * *

(2) Accountable plans--

(i) In general.

Except as provided in paragraph (c)(2)(ii) of this section, if an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, all amounts paid under the arrangement are treated as paid under an "accountable plan."

(ii) Special rule for failure to return excess.

If an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, but the employee fails to return, within a reasonable period of time, any amount in excess of the amount of the expenses substantiated in accordance with paragraph (e) of this section, only the amounts paid under the arrangement that are not in excess of

the substantiated expenses are treated as paid under an accountable plan.

* * * *

(4) Treatment of payments under accountable plans.

Amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes (Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), Railroad Retirement Tax Act (RRTA), Railroad Unemployment Repayment Tax (RURT), and income tax.) See paragraph (l) of this section for cross references.

* * * *

(d) Business connection--

(1) In general.

Except as provided in paragraphs (d)(2) and (d)(3) of this section, an arrangement meets the requirements of this paragraph (d) if it provides advances, allowances (including per diem allowances, allowances only for meals and incidental expenses, and mileage allowances), or reimbursements only for business expenses that are allowable as deductions by part VI (section 161 and the following), subchapter B, chapter 1 of the Code, and that are paid or incurred by

the employee in connection with the performance of services as an employee of the employer.

* * * *

(e) Substantiation--

(1) In general.

An arrangement meets the requirements of this paragraph (e) if it requires each business expense to be substantiated to the payor in accordance with paragraph (e)(2) or (e)(3) of this section, whichever is applicable, within a reasonable period of time. See section 1.274-5T or section 1.162-17.

* * * *

(3) Expenses not governed by section 274(d).

An arrangement that reimburses business expenses not governed by section 274(d) meets the requirements of this paragraph (e)(3) if information is submitted to the payor sufficient to enable the payor to identify the specific nature of each expense and to conclude that the expense is attributable to the payor's business activities. Therefore, each of the elements of an expenditure or use must be substantiated to the payor. It is not sufficient if an employee merely aggregates expenses into broad categories (such as "travel") or reports individual expenses through the use of vague, nondescriptive terms (such as

"miscellaneous business expenses"). See section 1.162-17(b).

(f) Returning amounts in excess of expenses--

(1) In general.

Except as provided in paragraph (f)(2) of this section, an arrangement meets the requirements of this paragraph (f) if it requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the expenses substantiated in accordance with paragraph (e) of this section. The determination of whether an arrangement requires an employee to return amounts in excess of substantiated expenses will depend on the facts and circumstances.

* * * *